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Pension Reform in the Netherlands

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Introduction

Like most developed economies, the Netherlands is struggling with its retirement system. The retirement of the baby-boom generation in combination with significant upward shocks in life expectancy, put pressure on so-called pay-as-you-go systems, in which the current labour force pays the benefits of current pensioners. Apart from a pay-as-you-go first pillar, the Dutch have a well-developed second pillar of fully funded pension funds. Despite its size and strength, this part of the system has experienced important reforms over the last decade and more changes are likely to be implemented in the near future. This contribution will focus on second-pillar pension funds.

Institutional Structure: Three Pillars

As in most developed countries, the pension system in the Netherlands is organised as a three-pillar system.

The first pillar comprises the public pension plan, offering a flat-rate pension to all retirees based on the number of years they have lived in the Netherlands. Financing is on a pay-as-you-go basis and benefits keep pace with the legal minimum wage. At retirement, a couple will receive an income of approximately €1400 a month (£1120), and a single person €1000 (£800). Since the 1950s, the formal retirement age has been 65, but recently a stepwise increase to 67 in 2023 has been agreed upon. After 2023, the retirement age will be linked to improvements in life expectancy, such that the period over which state pension is received is equal for each generation.

The second pillar provides retired workers an additional income from supplementary plans. Most second-pillar plans are mandatory funded defined benefit (DB) plans. Most of the 400 pension funds in the Netherlands aim to provide wage indexation or price indexation to accrued rights and benefits. More than 90 per cent of the Dutch labour force is covered by these funds, with the remaining self-employed or employed in companies smaller than 10 people. Finally, the third pillar comprises voluntary personal savings.

Second-Pillar Pension Funds

There are three types of pension funds in the Netherlands. The dominant type in size is the industry-wide pension fund, organised for a specific industry (eg construction, health care, or transport). Participation in an industry-wide pension fund is mandatory for all firms operating in the sector. A company can opt out only if it establishes a corporate pension fund that offers a better pension plan to its employees than the industry-wide fund. Where a supplementary pension plan exists, either as a corporate pension fund or as an industry-wide pension fund, participation by workers is mandatory and governed by collective labour agreements. The third type of pension fund is the professional group pension fund, organised for a specific group of independent professionals such as physicians or notaries[1]. The number of pension funds has shrunk significantly over the past years, from around 1000 in the year 2000 to less than 400 in 2015. Most smaller funds have been absorbed by their bigger counterparts, while some were liquidated. For corporate funds, the mandatory consolidation with their sponsor's balance sheet was a key motivation to change the setup. Another important cause was the introduction of much stricter requirements for trustees which made it more difficult to find the right people. A final cause was the increased administration and service costs. Due to stricter rules regarding transparency, corporate funds are not able to hide costs from the fund's profit and loss statement. The consolidation trend is accommodated and even promoted by the regulator which has always voiced the wish to bring the number of funds down significantly.

The Dutch pension fund system is one of the largest in the world, covering over 90 per cent of the active labour force, ranking fourth in total assets under management. The value of assets under management November 2014 amounted to €1150bn (£920bn), or approximately 175 per cent of Dutch gross domestic product (2014).[2] Funds are generally organised as foundations, owned by plan members, so as not to be at risk of being bought by fund managers.

Originating in the 1950s, pension funds in the Netherlands were initially set up as traditional DB plans, similar to those in the United States and United Kingdom. Over the past quarter century, DB plans in those countries have largely been displaced by individual defined contribution (DC) plans, while most pension plans in the Netherlands have maintained their DB structure. Within this structure, however, the Dutch funds have undergone significant change. In 2003, in the wake of the collapse in funding levels from the dotcom bust, the Dutch government imposed strict funding requirements and new accounting rules. Most importantly, pension liabilities were to be valued using a risk-free market interest rate (in practice the euro swap curve was prescribed), instead of a fixed rate of four per cent. In response, in order to improve risk management, most pension funds switched to what may be called 'hybrid' DB plans with conditional indexation, while others shifted even further to collective DC plans.

In the hybrid DB plans with conditional indexation, benefits are calculated as in traditional DB plans except that indexation of pensions in payment and accrued benefits is conditional on the plan's funding status. Collective DC plans are equal to hybrid DB plans with one main exception: contribution rates are fixed for at least five years. As all risks are borne by plan members and the

[1] More than 80 percent of all pension funds are of the corporate pension fund type. Of the remaining 18 percent, most are industry-wide funds, besides a small number of professional group funds. The industry-wide pension funds are the dominant players, both in terms of their relative share of total active participants (>85 percent) and assets under management (>70 percent). Around 300 corporate pension funds encompass about a quarter of the remaining assets. The 12 professional group pension funds have on average almost €2 billion under management.

[2] OECD, 2013, Pensions at a Glance 2013, Paris: OECD.

employer no longer assumes risk, a collective DC plan qualifies as a DC plan and it is treated as such under the International Financial Reporting Standards (IFRS), which is perceived as attractive for the sponsoring companies of corporate funds. Box 1 provides more information on specific features of Dutch plans.

A key variable in pension supervision is the nominal funding ratio, defined as the market value of assets over the market value of nominal liabilities. Liabilities are valued using the risk-free nominal market interest rate curve with some adjustment.[3] The relationship between the funding position and the indexation often is organised via a so-called ‘policy ladder’, which links indexation to the funding level (compare Figure 1 below). The rules for providing indexation will be changed with the introduction of the new supervisory framework as from 2015 onwards. The key principle to link the indexation to the funding ratio remains (see the next section).

Box 1: Key characteristics of Dutch pension funds

The following are key features of pension plans in the Netherlands (as of the end of 2014).

• Uniform accrual rate:
Employees build up for each year of service of 1.875 per cent of their (pensionable) wage as new pension rights. For example, a career of 42 years may give a pension income of 80 per cent of the average wage over the individual’s career – on average, this implies benefits of around 70 per cent of final pay.

• Uniform contribution rate:
All employees pay the same contribution rate, which is set yearly such that the annual contributions match the present value of new accrued liabilities by employees, based on each additional year of service, plus buffer requirements and indexation goals.

• Uniform indexation rate:
The accrued benefits of all plan participants are indexed yearly in a uniform way. Usually the aim is to index with the wage growth rate of the industry or that of the company offering the pension fund. A number of pension funds differentiate between their indexation policy for employees (indexation linked to wages) and retirees (indexation linked to price inflation). The actual indexation rate is conditional on the financial position of the pension fund.

• Uniform asset mix:
Pension fund wealth is invested in one asset mix.

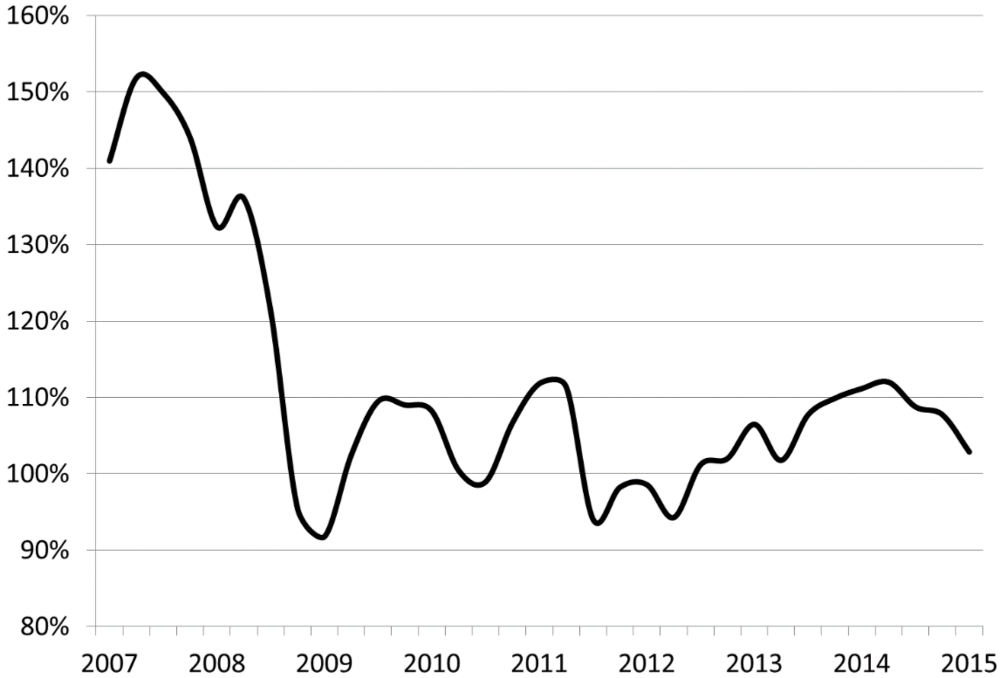
Current Debate on Pension System Redesign

Following the restructuring of most Dutch pension plans in the early 2000s, the average funding ratio slowly recovered. However the average funding ratio fell dramatically since the start of the economic crisis, from a high of 150 per cent in mid-2007 to less than 90 per cent in the first quarter of 2009 (see Figure 1). Although stock markets recovered after their initial fall, the strong decline in interest rates drove up the (market) value of nominal liabilities. Since then, the conditional indexation rule prevented most pension funds from providing any indexation, but many funds even had to reduce

[3] Currently, the discount curve is based on the Euroswapmarket, adjusted for maturities above 20 years using an ultimate forward rate methodology.

benefits as it proved impossible to recover to the required 105 per cent threshold within the maximum recovery period.

Figure 1: Nominal funding ratio of a typical Dutch pension plan, March 2007 – June 2015



Source: Estimate based on data from DNB (www.dnb.nl)

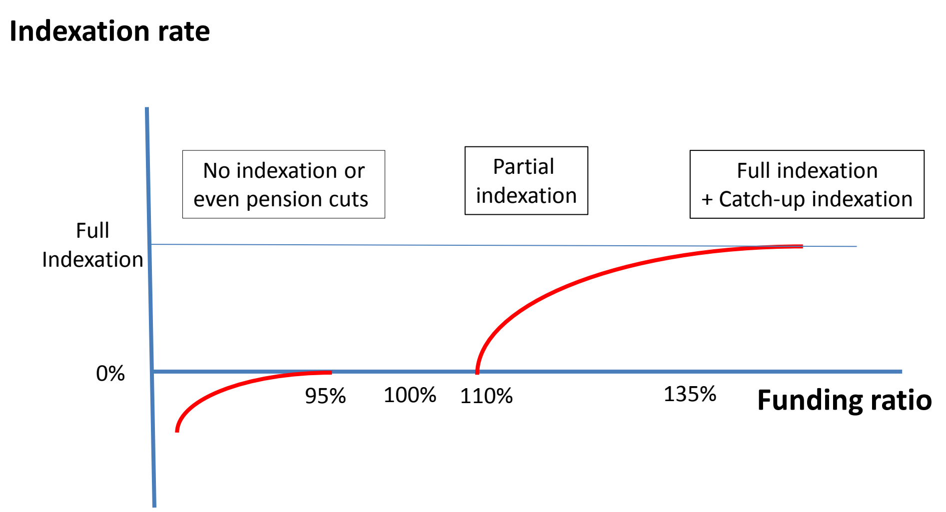
In the aftermath of the sharp decline in the funding position in 2008, representatives of labour unions, employers and the government started up negotiations on a plan redesign in order to make the system more shock-resilient. Two types of shocks in particular were considered: first, shocks in life expectancy, and second, shocks in financial markets. The reform makes the pension plans less prone to sudden and severe pension cuts to solve underfunding. Moreover, the plan reset is applied with a check on generational fairness. The new practice as of 2015 is structured as follows. Two funding ratios play a central role in the new setup. First, is the current nominal funding ratio, which will be smoothed over the previous 12 months in order to limit excess volatility. And the second is the required funding ratio defined by rules set by the supervisor. This required funding ratio has a direct link with the investment risk taken in the fund's financial strategy. A typical pension fund will have a required funding ratio between 125 per cent and 130 per cent. Should the funding ratio fall below this level, funds have to indicate how they expect to recover within the following 10 years. Only in the case of strong underfunding, this will lead to cuts in nominal benefits. This is a major relaxation compared to the previous regulations, and it is especially beneficial to the older participants. To maintain generational balance, however, the reform simultaneously defines a less generous policy regarding indexation. Full indexation is still possible but only at much higher funding ratios.

Indexation might be given as far this is allowed within the framing of restoring the financial position in 10 years' time. When, based on the prescribed set of rules and return assumptions, the required funding ratio will recover in a shorter period of time, the pension fund may provide some indexation. The bottom line is that cutting pensions is less likely, but providing full indexation has also become more difficult.

Figure 2 sketches the main relationship between the nominal funding ratio (along the horizontal axis) and the indexation rate (along the vertical axis). Full indexation can be provided when the nominal funding ratio is higher than a specified threshold, typically around 135 per cent when wage indexation is aimed at. When the funding ratio is above this threshold, this overfunding can be used to provide catch-up indexation to restore missed indexation and negative indexation (cuts) in previous years. Funds with funding ratios deep below 100 per cent, say 95 per cent and lower, cannot escape from falling back on pension cuts to meet the supervisory requirements.

Figure 2 depicts how the new indexation policy is non-symmetrical in nature, as the cumulative provided indexation never can surpass the level of full indexation, whereas cuts can be given without any limit. The counterpart is that the new rules preclude more prudency and higher funding ratio levels in the longer run.

Figure 2: Indexation rules summarized by the Policy ladder



More radical reforms are currently under discussion. Part of the debate focuses on the use of the uniform contribution rate in combination with a uniform accrual rate (compare Box), which leads to undesirable value transfers among certain cohorts within the fund to others. This aspect of the current system prevents moves to cater to individual wishes of participants who display heterogeneity in career, income level, life expectancy. The uniformity in accrual and contributions leads to value redistribution from low- to high-income workers, from short-living (male) to long-living (female) participants, and from early careers to late careers. While in the past this was hardly known and understood, these transfers have become more transparent and considered undesirable. Reducing redistribution to acceptable levels is a tough and expensive challenge and probably it will play a major role in the reform agenda in the coming years.

Conclusion

Over the last decade, the Dutch pension system has shown a large capacity to adapt the settings of the three pillars to changing circumstances. Final pay is replaced by average wage schemes and the introduction of market valuation of pension liabilities has provided a major incentive to the creation of a more robust pension system in absorbing shocks in financial markets, while maintaining the benefits of risk sharing within and across generations. The next challenge is to reshape the second pillar to take into account changing lifecycle patterns. Pension funds are likely to remain collective in nature, but more room will be provided to accommodate diversity in lifecycle and career patterns.

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